



## **Response to Crowd Sourced Equity Funding Discussion Paper**

### **Regulation for a digital era**

*CSEF is the first of many digital disruptors that are heralding a paradigm shift in capital funding. These cloud based technologies are exceeding the capacity of pre-digital legislative frameworks to regulate.*

## Forward



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Solutions4Strategy works with the retail banking sector, start-ups and cooperatives assisting with strategic planning, regulatory reporting, technology innovation and risk management.

Solutions4Strategy has been in a unique position of observing the SME funding crisis from both the business owners' perspective and the investor/lender perspective, and in doing so have been pursuing strategies to resolve the current funding crisis that has been hindering economic growth and employment. Solutions4Strategy has likewise been involved in innovation including digital disruptors such as peer to peer lending, crowd funding and other technologies.

## Objective of Response

### *Balance between funding business and protecting investors*

Solutions4Strategy seeks to have a more balanced approach of meeting the needs of business and protecting investors. The discussion paper's focus was on the regulation of crowd funding and protection of investors. There was little discussion around the problems SMEs have in accessing funding or how CSEF would be used to resolve those issues. The suggested direction is applying odious restrictions to CSEF that would make it unviable for businesses and fails to protect investors.

### *Modifying regulation for a digital era*

The discussion paper missed a critical aspect in that crowd funding as part of a range of digital disruptors that are causing a paradigm shift in the fund raising sector. The concern is that treasury is applying an outdated legislative framework that is failing to keep pace with the depth of changes being driven by a digital era of innovation.

### *Input from individuals with a practical knowledge of the technology*

Solutions4Strategy has further concerns that there was a lack of input from people who had practical knowledge of technology and innovation, where the suggested approach is impractical for dealing with the new global internet based economy that crowd funding is a part of.

### *Perspective of funding needs from SMEs and other types of business entities*

The purpose of the response is to provide a perspective from the SME business owners and other forms of businesses including co-operatives, mutuals and private companies. The legislative approach needs to be rethought to maximise the economic opportunity that crowd funding will provide.

This response will provide some technical aspects that need to be considered in better shaping the legislation.

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## Introduction

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The government has to have the courage to avoid creating unnecessary red tape, if Australia is to be a global leader in innovation that grows exports, tax revenue and employment. It is unlikely that the suggested CSEF regulation will provide consumers any of the protections which is driving the thinking behind the regulation. However it will have an adverse impact on businesses ability to access CSEF as a much needed source of capital, which is the critical economic requirement.

This response paper will raise the following issues.

1. CSEF is a digital disruptor not a capital instrument. It is threatening established players who for too long have used their market power to derive unjustified returns for poor facilitation of the funding needs of business. The status quo is hindering economic growth and government needs to encourage competition, not restrict competition.
  - a. The Government should not unnecessarily interfere or restrict free market competition that would drive down price and increase service.
  - b. There already exists a market failure in funding for the SME sector post GFC. Government has to take action and CSEF is a critical solution for tackling this current market failure.
2. There is a fear of the unknown derived from a lack of understanding and knowledge around the technologies and innovations at play here. This fear drives an overly conservative approach to legislation that is firstly too restrictive and secondly fails to protect consumers
  - a. Threatened market players will promote fears to encourage legislators to restrict the competitive threat of CSEF and the Government should not cave into such protectionism.
  - b. The government needs to recognise that CSEF will provide greater transparency and governance than currently exist and should not burden CSEF with overzealous compliance that does not apply to other financial products.
3. The pace of innovation is overtaking the current legislative framework which is designed for a pre-digital commercial era. Legislation needs to be reshaped for a new era of global, internet based financial products and services.
4. Regulation should not be implemented that is beyond the resources of regulators to enforce.
  - a. Too often regulations are not enforced due to a lack of resources, where the honest business is constrained and the dishonest proceeds to rip off the public without repercussion. Why restrict honest business with laws that will not be enforced.
5. Treasury needs to expand its thinking to business plurality where there are more business structures than just Public Listed Companies and Equity Funding goes beyond just shareholding.
  - a. CSEF could be a form of preference share in an existing private company
  - b. CSEF could be in the form of Co-operative Capital Units for co-operatives
  - c. CSEF could be in the form of tier one capital for a Credit Union

## Treasury should not legislate to restrict free market forces

Treasury needs to rethink CSEF as not being a new capital instrument but as one of many digital disruptors that are causing a paradigm change in the fund raising sector. Entrenched players have been able to extract unjustified returns through their market control and CSEF is a technological innovation that bypasses that market control creating competition in a market that desperately needs competition.

### \$10K limitation in total investments

The limitation of \$10,000 of investment in CSEFs per annum is a restriction that has no practicality other than to restrict the competitive threat CSEF will have on entrenched market players. The Government does not restrict the level of consumer investment in real estate, shares and other schemes, why such a restriction in CSEF unless Treasury is recommending protectionism for entrenched players including investment banks. The issue of limited prospectuses is covered by limiting the individual investment in each individual scheme, there should be no restriction for the amount that investors put into a range of schemes.

This would be difficult to enforce and provides no beneficial protection of consumers.

### Governments role is not to protect bankers threatened by CSEF

Investment bankers have made huge profits over the years from controlling the fund raising market. CSEF is a digital disruptor that allows companies and investors to bypass organisations such as investment bankers.

It would be open to question whether restrictive legislation placed on CSEF is more about protectionism for bankers than it is about protecting investors. We would urge the Government to step cautiously into why they are over zealously restricting CSEF. Are investment bankers providing advice and if so, is this advice tainted by self-preservation.

### Unnecessary restrictions in where CSEF can be used

That CSEF could only be used for a special public company is a restriction that prevents CSEFs being used to provide funding in other areas of business. There is no reason for such a restriction other than preventing free market forces from threatening established players in the capital funding sector.

CSEF could be used as other forms of capital instruments that would benefit businesses and investors equally and provide a much needed boost to the economy.

## Regulation for a Digital Era of Commerce

Current legislation is a legacy of an era before the digital economy and legislation is failing to keep pace with digital innovations in finance. Taxation is a great example where legislation is not keeping pace with digital commerce. Google invoices in Ireland the business conducted in Australia avoiding Australian tax. Internet shopping overseas avoids GST. If legislation was designed initially for a digital e-commerce era, then these loop holes would not have existed to avoid tax as is happening now.

### Regulating for a Paradigm shift in capital raising, not just a new instrument

CSEF should not be treated as just another capital instrument, but rather as part of a range of digital innovations in finance, which is driving a paradigm shift in the financial services market. The legislation should be for digital disruptors, of which CSEF is just one of a new range of products.

In this light, it would be an error in judgement to try and mangle pre digital era legislation to manage a digital era instrument that goes beyond what entrenched legislation ever dealt with. Legislation needs to be rethought to manage a digital, global instrument which will provide the framework for future instruments such as bitcoin.

### Legislation is failing to regulate digital disruptors

Government needs to rethink how it regulates a digital economy. Government's fear of crowd funding is that it cannot be controlled in the traditional manner, however denial and avoidance will not resolve the problem.

Uber is a glaring example where regulators are failing to manage a digital disruptor. Uber is an app-based transportation network and taxi company headquartered in San Francisco, California that is worth \$40B. It is a digital disruptor to the taxi industry, where a false market value has been created by tightly restricting taxi plates (ie a monopoly). Despite it being illegal, regulators are facing a losing battle to stop something that consumers are demanding. Uber with a market value of \$40B has more resources than the regulators have. Rather than trying to stop it, regulators should be working out how to manage it.

### Regulating a global market instrument

The internet breaks the geographical boundaries. An Australian investor can invest in a CSEF scheme in Singapore, an Indian can invest in a CSEF scheme in Australia. There would be nothing to stop an Australian setting up a CSEF scheme in Singapore for Australians to invest in an Australian company.

The suggested regulation has been limited to thinking that all the players and all the transactions will occur within Australia, this is not the case. At this moment an Australian Peer to Peer Lender is raising capital through the use of New Zealand CSEF. Regulation needs to deal with transactions beyond the geographical boundaries that no longer exist on the internet.

### Managing volumes of small transactions rather than the few large transactions

Regulators have a preference for fewer players making bigger transactions. This drives overzealous regulation against small businesses compared to their stance on bigger businesses. Whilst their logic is that few bigger players are easier to regulate than numerous small players, the reality is that there is a move towards numerous small volume transactions between numerous small players.

Regulators need to adjust their regulatory mechanism and regulation to deal with volumes of small transactions.

## Balancing SMEs access to funding versus protecting investors

The current legislative approach suggested for CSEF has failed to find a balance between solving the funding crises for SME businesses and protecting investors where the papers focus is totally on protecting investors. Ironically whilst the aim to protect investors is admirable, the reality is that such legislation has failed miserably with scams and frauds still being prevalent. All that has happened is that Australia has significant red tape that hinders economic growth.

## Collapse of funding to SME business post GFC is impacting on economic growth

The ratio of business lending to home lending has halved. There is \$14B on personal credit cards of business owners because they cannot get an overdraft. Banks want mortgage secured business loans, but due to the cost of housing, there is a growing proportion of Australians who do not own a home or if they do, they have little equity to borrow against. At the same time equity funding and venture capital has dried up. Other forms of businesses such as co-operatives don't have access to capital raising that public listed companies have. ASIC has created overly onerous rules for private companies to raise funds where the cost of capital raising is tenfold that of corporate.

## \$30M gambled on Melbourne Cup and these investors lost most of their money

On Melbourne cup \$30M was gambled and lost by investors/gamblers. If that \$30M had been put into business to fund growth and employment, this would have been a tremendous boost to the economy. Why do we have such onerous rules around fund raising compared to the less onerous rules around gambling? It is not the intention to suggest that there should be no investor protection, but to challenge the notion that regulators should caution towards investor protection at the detriment of the ability of business to raise funds.

Why do regulators restrict gambling on business, but apply little restriction to gambling on horses. This is irrational and some common sense needs to be applied to regulation.

## Investors not protected by current regulation

Scams cost Australian's \$93M in 2012. Our regulatory processes failed to protect those investors and few scammers have been convicted in purporting such scams. Instead we have significant red tape hindering legitimate business from raising legitimate capital.

In regulating CSEF, the Government needs to consider the balance between protecting investors and hindering business unnecessarily. Particularly where the created red tape is not achieving any practical protection of investors.

## Regulation that cannot be enforced should not be implemented.

Considerable regulation in Australia is not enforced due to the limited resources and legal difficulties in enforcing such regulation. What is occurring in Australia, is that dishonest business people proceed to profit by breaking the law without fear of prosecution, whilst honest business people have their hands tied by following laws that others ignore.

The regulation suggested in the CSEF discussion paper cannot be enforced as no regulator has the resources to monitor and prosecute breaches. It is creating unnecessary red tape that is not enforceable and regulation should be scaled back to a more realistic and rational level. The \$10K limit is not enforceable, so why put it in.

## CSEF goes beyond a share in a public company

The discussion paper failed to consider how CSEF could be used to meet the capital demands of the SME sector and is only considering one option. A public company is not the only option and there are some limitations in the structure suggested.

### How do start-ups take advantage of CSEF

A start-up will have initial shareholders including initial investors, employee schemes and angel investors. How does this shareholding transfer to a special public company for CSEF purposes? CSEF would need to be one form of shareholders in a company and not the only form of shareholding in a business as suggested.

### Co-operatives

In a co-operative, the members are the shareholders. A co-operative structure cannot have CSEF shareholders, however co-operatives do have a debt-equity instrument "Co-operative Capital Units" that would be ideal for CSEF. The current approach to CSEF would not allow such an instrument to be available for CSEF.

### Private Companies

Equity Crowd funding would fit well into a private company as a form of preference share. These shares would have priority over other equity owners but would come after creditors in the case of liquidation.

### Mutual Banks and Insurance companies

Credit Unions, Building Societies, Mutual Banks and other mutual financial insurance organisations require greater tier one capital. Mutuals as with co-operatives cannot have non-member shareholders to fund tier one capital and hence CSEF in its current form would not work. However a special instrument could be set up with CSEF that would provide tier one capital that meets APRA requirements. This would help to promote greater banking competition.